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FEDERAL INCOME TAXATION OF INTANGIBLE DRILLING AND DEVELOPMENT COSTS

by

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IN the development of oil, gas and geothermal properties, intangible drilling and development costs (IDCs) are invariably incurred by the operator. Briefly, IDCs are expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for production, and which in themselves do not have a salvage value.[1] Historically, in relation to

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[1]Treas. Reg. § 1.612-4(a) (1965); Temporary Treas. Reg. § 5a.612-1(a) (1980).

In order to understand the nature of IDCs, it is helpful to examine the setting in which they arise, i.e. the development of mineral property. In the case of an oil or gas property, the process begins with the search for commercial oil deposits containing oil of a marketable specific gravity and producible viscosity. These deposits are generally found in the presence of porous and permeable rock formations called reservoir traps. A reservoir trap is typically a layer of sedimentary rock covered by another layer of impervious matter which is folded in such a way as to prevent the natural upward flow of petroleum. Geologists employ a number of devices such as gravity-meters, magnetometers and seismographs in the search for reservoir traps. Information from tests conducted with those devices together with core tests from exploratory wells are used to determine future well sites.

Although there are other drilling methods, the most widely used method is the rotary drilling rig. The bit of the rotary drill consists of three interlocking movable wheels with sharp teeth which bore a hole through the various layers of rock and sand by continuous turning of the bit. The bit is attached to hollow lengths of pipe connected together leading to the surface. As the hole gets deeper more lengths of pipe are connected at the top. While the drill is operating, an expensive chemical compound in fluid form circulates continuously down the drill pipe, through the bit, into the hole and upwards between the hole and the pipe to a surface pit, where it is purified and recirculated. The constant flow of this substance called "mud" removes the cuttings from the hole without necessitating removal of the bit, lubricates and cools the bit in the hole, and prevents blow-outs in high pressure strata.

When the drill reaches potential oil or gas bearing formations, a drill stem test is similar development costs in other industries these costs have been given favored income tax treatment by the United States government. This special treatment has its roots in some of the earliest federal income tax legislation and administrative rulings. The complexity of this area of taxation has burgeoned over the ensuing years and has been compounded by the generally complex taxation and property law aspects of the oil, gas and geothermal industries in an era of rapid technological advances, economic fluctuations and worldwide energy concern.

Basically, the favored tax treatment appears in the form of an option given to the taxpayer-operator to expense IDCs currently rather than to capitalize them and recover his investment through depreciation or depletion.[2] Until 1976, this tax benefit was completely unfettered by subsequent tax burdens. In the Tax Reform Act of 1976, section 1254 was added to the Internal Revenue Code of 1954, providing in essence for the recapture of IDCs previously expensed upon disposition of the subject oil or gas property. In order to understand the impact of section 1254, it is first necessary to explore the historical background and nature of IDCs in their many contexts.

LEGISLATIVE HISTORY OF IDCs

The starting point for a discussion of the tax treatment of IDCs must begin with section 263(a) of the Code. That section provides the general rule that no deduction shall be allowed for an amount paid out for new buildings, permanent improvements or betterments made to increase the value of any property or estate. Expenditures of that type are to be capitalized, and if they qualify, recovered through depreciation under section 167. To this general rule, section 263(c) in its current form states an exception, granting the taxpayer an option to expense certain IDCs in the case of oil, gas and geothermal wells. In its original 1954 version, subsection (c) authorized the Secretary of the Treasury to prescribe regulations corresponding to the regulations which granted the option to deduct as expenses IDCs in the case of oil and gas wells and which were recognized and approved by the seventy-ninth Congress in House Concurrent Resolution 50. By the

usually conducted by a device lowered into the hole to test the pressure of the flow of fluids from the formation into the instrument. After a successful drill stem test, a new string of pipe called casing is placed into the hole and set with cement. Thereafter, by use of a device lowered into the well, holes are blown through the casing and cement thereby allowing oil and gas to enter the well bore. Sometimes it is necessary to increase the permeability of the reservoir rock by acidizing (chemical treatment) or by hydraulic fracturing (application of pressure which fractures the rock). An oil well is completed when the "Christmas tree" (a complex set of gauges and valves controlling the flow of oil and gas from the well head) is installed. H. WILLIAMS, R. MAXWELL & C. MEYERS, CASES AND MATERIALS ON THE LAW OF OIL AND GAS 2-7 (2d ed. 1964).

Revenue Act of 1978,[3] subsection (c) was amended to include IDCs attendant with geothermal wells within the same option. The regulations referred to in section 263(c) are presently found in Treasury Regulation section 1.612-4.[4]

Although the origin of the option to expense IDCs in the case of oil and gas wells can be traced to a loosely worded provision in the Revenue Act of 1918, the validity of the option was a subject of controversy until the enactment of the Internal Revenue Code of 1954. Section 214(a)(10) of the 1918 Act provided a deduction for depletion and for depreciation "according to the peculiar conditions in each case based upon cost, including cost of development not otherwise deducted." From the "not otherwise deducted" language of that statute, oil and gas operators urged that, by implication, IDCs were deductible in the year they were incurred. Further support for the expensing of IDCs was provided in 1918 by revision of the then existing federal income tax regulations to permit the option to expense IDCs incurred in oil and gas drilling.[5] Similar provisions have appeared in subsequent revisions of the Treasury Regulations up to the present time.

Without reaching the issue of the statutory authority for issuance of the regulation permitting the option, the United States Court of Appeals for the Sixth Circuit affirmed the decision of the United States District Court for the Western District of Kentucky in the 1931 case of *Sterling Oil & Gas Co. v. Lucas*.[6] In that case, the lower court specifically upheld the taxpayer's exercise of the option to deduct IDCs currently in a situation involving the 1918 Revenue Act. However, the option met its first serious challenge in 1945 at the hands of the United States Court of Appeals for the Fifth Circuit in the case of *F.H.E. Oil Co. v. Commissioner*.[7] After deciding that a producing well was a permanent improvement, the court held that the statutory predecessor of section 263(a) then in effect took precedence over the option granting regulation, thereby prohibiting the option to deduct IDCs as expenses.[8] The court reasoned that such costs should be capitalized and recovered through depletion. In the absence of statutory authority, the court held that no congressional approval for the regulation could be presumed.[9]

In response to the *F.H.E. Oil Co.* case, Congress in 1945 adopted Concurrent Resolution 50[10] which states:

> Resolved by the House of Representatives (the Senate concurring), That in the public interest the Congress hereby declares that by the

[3]I.R.C. § 263(c), as amended by the Revenue Act of 1978, Pub. L. No. 95-618, § 402(a).

[4]Treas. Reg. § 1.263(c)-1 refers to Treas. Reg. § 1.612-4.

[5]Harper Oil Co. v. United States, 425 F.2d 1335, 1338 (10th Cir. 1970).

[6]62 F.2d 951 (6th Cir. 1933), *aff'g* 51 F.2d 413 (W.D. Ky. 1931).

[7]147 F.2d 1002 (5th Cir. 1945).

[8]*Id.* at 1005-06.

[9]*Id.* at 1005.

[10]59 Stat. 844 (1945).

> reenactment, in the various revenue Acts beginning with the Revenue Act of 1918, of the provisions of section 23 of the Internal Revenue Code and of the corresponding sections of prior revenue Acts allowing a deduction for ordinary and necessary business expenses, and by the enactment of the provisions of section 711(b)(1) of the Internal Revenue Code relating to the deduction for intangible drilling and development costs in the case of oil and gas wells, the Congress has recognized and approved the provisions of section 29.23(m)-16 of Treasury Regulations 111 and the corresponding provisions of prior Treasury Regulations granting the option to deduct as expenses such intangible drilling and development costs.[11]

Nine years later, Congress added section 263(c) to what became the Internal Revenue Code of 1954, thereby creating firm congressional authority for the option to deduct IDCs.

OTHER DEVELOPMENT COSTS DISTINGUISHED

IDCs incurred in developing oil, gas and geothermal properties occur in conjunction with a variety of other costs which receive different tax treatment. Before discussing at length the nature and tax consequences of IDCs, it is prudent to distinguish those other expenditures and their respective tax treatment. The distinction between IDCs and other costs is often unclear and has been the subject of substantial litigation.

Prior to 1950, geological and geophysical exploratory expenditures incurred in the search for oil and gas deposits were generally permitted as ordinary and necessary business expenses deductible under section 162 and its predecessor statutes. However, in 1950, the Commissioner of the Internal Revenue Service declared that such costs did not qualify as business expenses.[12] Therefore, if property is acquired or retained following exploratory expenditures, then those costs must be capitalized as part of the cost of the property. However, if, following the expenditures, the subject property is not acquired or retained, then the costs are deductible as a loss under section 165.[13]

Expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value do not qualify for the option. These are capital items, and, among other things, consist of the actual material in the structures constructed at the wells, the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc.[14] Similarly, expenditures for wages, fuel, repairs, hauling and supplies, in connection with structures for storing or treating oil or gas and other equipment, facilities or structures which are not incident to or necessary for the drilling of wells are capital items. Costs incurred in

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[11] *Id.*

[12] I.T. 4006, 1950-1 C.B. 48.

[13] 4 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 24.51a (1973).

[14] Treas. Reg. § 1.612-4(c)(1) (1965); Temporary Treas. Reg. § 5a.612-1(c)(1) (1980).

this regard must be capitalized and recovered through depreciation.[15]

Another type of expenditure which does not qualify as an IDC consists of labor, fuel, repairs, hauling, and supplies necessary to keep the well in operation between the time of its completion and the time when production has begun. Such expenditures are current expenses which are deductible in the year in which they are incurred.[16] The taxpayer may not elect to capitalize any part of such items. Among these expenditures are taxes, overhead expenses, depreciation of drilling equipment and "lifting costs" (the cost of bringing the oil or gas out of the ground after completion of the well and prior to removal from the property).[17]

The remaining general group of expenditures attendant with oil, gas and geothermal property is the IDCs. These are expenditures made by an operator for wages, fuel, repairs, hauling, and supplies, incident to and necessary for the drilling of wells, and the preparation of wells for production.[18] Examples of IDCs are all amounts paid for labor, fuel, repairs, hauling and supplies used in the drilling, shooting and cleaning of wells, clearing of ground, draining, digging sludge pits, laying lines for water, road making, surveying and geological works necessary in preparation of wells for production, construction of derricks, tanks, pipelines and other physical structures necessary for the drilling of wells and the preparation of wells for production. Generally, these items of expenditure do not have a salvage value in and of themselves.[19] As to these items, the taxpayer is given an option, exercisable in the first year in which such expenditures are made, either to deduct them as expenses from gross income in the year in which they are incurred or to capitalize them and recover them by depreciation or depletion.[20]

Where a taxpayer elects to capitalize rather than expense IDCs, it is then necessary to determine which IDCs are represented by physical property and which are not. IDCs which are not represented by physical property are recovered through depletion[21] and such costs are added to the taxpayer's basis otherwise computed for the purpose of

[15] *Id.*

[16] Treas. Reg. § 1.612-4(c)(2) (1965); Temporary Treas. Reg. § 5a.612-1(c)(2) (1980).

[17] 4 J. MERTENS, *supra* note 13, at § 24.47.

[18] Treas. Reg. § 1.612-4(a) (1965); Temporary Treas. Reg. § 5a.612-1(a) (1980).

[19] *Id.*

[20] *Id.* The option to expense IDCs may be made by claiming them as deductions on the taxpayer's return for the first taxable year in which he incurs IDCs. No formal statement is necessary. Failure to deduct IDCs on the return will be deemed to be an election to capitalize those costs. Treas. Reg. § 1.612-4(d) (1965); Temporary Treas. Reg. § 5a.612-1(d) (1980).

In the case of a taxpayer who has elected to capitalize IDCs rather than to expense them, an additional option is provided in the case of a nonproductive well. IDCs incurred in drilling a nonproductive well may be deducted as an ordinary loss provided that a proper election is made. Treas. Reg. § 1.612-4(b)(4) (1965); Temporary Treas. Reg. § 5a.612-1(b)(4) (1980).

[21] Treas. Reg. § 1.612-4(b)(1) (1965); Temporary Treas. Reg. § 5a.612-1(b)(1) (1980).

determining cost depletion under section 611. Where the taxpayer employs cost depletion in computing taxable income from the particular property for the year, a ratable share of the IDCs incurred will be recovered in the depletion allowance. However, if instead of cost depletion the taxpayer uses percentage depletion under section 613A, then he will not recover any part of his IDCs,[22] since percentage depletion is computed in terms of a specified percentage of gross income from the property. The taxpayer is not permitted to take a depletion allowance on IDCs "not represented by physical property in addition to the percentage depletion."[23] Moreover, where IDCs are deducted in computing taxable income, they must also be deducted when computing the percentage depletion limitation of fifty percent of taxable income from the property.[24]

IDCs represented by physical property which are elected to be capitalized must be recovered through depreciation under section 167 in the same manner as any other property qualifying under that section.[25] In addition to straight-line depreciation or the unit of production method,[26] in appropriate cases, the declining balance method or the sum of the years-digits method will be available.[27]

As mentioned above, there has been a considerable amount of controversy as to what constitutes an item of IDC. Regulation section 1.612-4(a) provides that labor, fuel, repairs, hauling, and supplies are not considered as having a salvage value and are thus IDCs despite being expended in connection with the installation of physical property having a salvage value. However, the clear implication is that they will be considered IDCs only if the particular physical structure is necessary for the drilling of wells and the preparation of wells for production as opposed to being used in the actual production of oil or gas. Thus a dichotomy has been created between intangible expenditures made with respect to preparation for production and those connected with actual production.

Revenue Ruling 70-414[28] declared that expenditures incurred in installing production facilities such as pumping equipment, flow lines, separators, storage tanks, treating equipment and salt water disposal equipment are not items of IDC and are therefore excluded from the option. The ruling specifically excepts from the option the installation

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[22]4 J. MERTENS, *supra* note 13, at § 24.48.

[23]*Id.*

[24]Helvering v. Wilshire Oil Co., 308 U.S. 90 (1939), *rehearing denied*, 308 U.S. 638 (1939).

[25]4 J. MERTENS, *supra* note 13, at § 24.52.

[26]*Id.* The unit of production method of depreciation may be used where the expected economic life of an oil or gas deposit is shorter than the normal useful life of the physical property in question. In such cases, the depreciation deduction could be based upon the length of life of the deposit. The asset is depreciated in proportion to the number of units recovered each year. *Id.*

[27]*Id.*

[28]Rev. Rul. 70-414, 1970-2 C.B. 132.

costs of the following items: (1) oil well pumps (upon initial completion of the well), including the necessary housing structures, (2) oil well pumps (after the well has flowed for a time) including the necessary housing structures, (3) oil well separators, including the necessary housing structures, (4) pipelines from the well head to oil storage tanks on the producing premises, (5) oil storage tanks on the producing lease, (6) salt water disposal equipment, including any necessary pipelines, (7) pipelines from the mouth of a gas well to the first point of control, such as a common carrier pipeline, natural gasoline plant, or carbon black plant, (8) recycling equipment including any necessary pipelines, and (9) pipelines from oil storage tanks on the producing leasehold to a common carrier pipeline.[29] As in the case of the items of equipment themselves, the labor, fuel, repair, hauling and supply costs of installing the aforementioned items must be capitalized and recovered through depreciation.

In its 1976 decision *Exxon Corp. v. United States*,[30] the United States Court of Claims considered the application of the section 263(c) option to expenditures in the construction of offshore drilling platforms. The platforms were constructed in three phases. The first phase consisted of the designing of the platforms by reference to water depths, wind, tide and storm conditions. In the second or so-called land phase, a marine construction contractor would fabricate on land as much of the platform as was practicable. During the final or water phase the partially constructed platform was loaded on a barge for transport to the drilling site; additional welding, cutting and fitting work were performed on the platform pieces in transit; and the platform pieces were assembled and anchored to the sea floor at the drill site.

The plaintiff in every instance capitalized the cost of the actual materials used in constructing the platforms. The government conceded that all costs for labor, fuel, repairs, hauling and supplies incurred by the taxpayer for installation of the platform after it was lifted from the barge were properly within the option. At issue was the tax treatment to be accorded to the costs incurred prior to that time. The court held that such expenditures were within the option to expense.[31]

The court rejected the govenment's argument that all expenditures for labor, fuel, repairs, hauling and supplies made prior to commencement of the water phase and a portion thereafter, were expenditures by which the taxpayer "acquired" tangible property ordinarily considered as having a salvage value within the meaning of the predecessor of regulation section 1.612-4(c)(1) thereby requiring the capitalization of those costs.[32] Moreover, the court refused to give a narrow interpretation to the term "installation" in the pertinent regulation section

[29] *Id.* at 133.
[30] 547 F.2d 548 (Ct. Cl. 1976).
[31] *Id.* at 558.
[32] *Id.*

which allowed the option to apply to the costs for labor, fuel, repairs, hauling and supplies used in connection with the installation of physical property which has a salvage value.[33]

Rather than restricting the word "installation" and thus restricting the option to only those expenditures incurred in the course of installing the constructed property at the well site, the court stated that the purpose for the clause was to preclude the assertion that expenditures for labor, fuel, repairs, hauling and supplies acquire a salvage value of their own simply because they were connected with the installation of physical structures which have salvage values.[34] The court further reasoned that the regulation section expands the application of the option to include costs related to salvable property without these costs losing their characterization as nonsalvable items.[35]

In *Harper Oil Co. v. United States*,[36] the United States Court of Appeals for the Tenth Circuit was faced with the issue of whether the cost of surface-casing used in an oil well could be expensed within the option of section 263(c).

Production casing is commonly referred to as the "string." It consists of connected steel pipe lengths which are inserted into the drill hole to allow oil to flow to the surface. Surface-casing is an outer jacket of the string which is used, among other things, to prevent contamination of fresh water strata which have been penetrated.

Reasoning that casing of all kinds "ordinarily" would be considered as having a salvage value, the court held that the mere fact that an Oklahoma regulation required the taxpayer to cement surface-casing permanently into the hole did not prevent it from being considered as having a salvage value.[37] The court interpreted "ordinarily" as referring to casing in general and not to Oklahoma surface-casing in particular.[38] Since casing ordinarily has salvage value, the court determined that the subject surface-casing had salvage value despite the fact that it could not be removed from the well.[39]

Revenue Ruling 78-13[40] applies regulation section 1.612-4(c)(1) to expenditures for steel casing, casing shoes, centralizers, wall scratchers and other downhole expenditures made in connection with oil and gas wells and requires them to be capitalized. That regulation section provides that expenditures by which a taxpayer acquires tangible property ordinarily considered as having a salvage value are not within the option. According to the ruling, these items are subject to depreciation when an oil or gas zone is found and the well is capable of production.

[33]*Id.* at 556.
[34]*Id.*
[35]*Id.*
[36]425 F.2d 1335 (10th Cir. 1970).
[37]*Id.* at 1343.
[38]*Id.*
[39]*Id.*
[40]Rev. Rul. 78-13, 1978-1 C.B. 63.

In the event of a dry hole, if the casing and other downhole equipment is abandoned, such costs are deductible as a loss under section 165.

QUALIFICATION OF THE TAYPAYER

The inquiry as to the current deductibility of an item of IDC pursuant the option authorized by section 263(c) is not concluded after an examination of the item itself. There remains the additional issue of whether the particular taxpayer who seeks to exercise the option can qualify for its benefits. The resolution of that issue can be as complex as the property law concepts governing the property interests in oil, gas and geothermal property. Regulation section 1.612-4(a) makes the option available to IDCs made by an "operator." That regulation section defines an operator as one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights in the development of oil and gas properties (and now geothermal properties as a result of the 1978 amendment to section 263(c)).[41]

In the context of oil, gas and geothermal properties, "working" interests and "operating" interests are interchangeable terms. The owner of the working interest bears the burden of all costs in locating deposits and lifting the mineral from the ground. It is quite common for a landowner in a lease arrangement to assign the lion's share of the working interest in a property to an operator-lessee. Frequently, the lessor retains a fraction of the working interest which entitles him to a similar fraction of the minerals produced. In many instances, the lessor by agreement retains his working interest free of any costs of development. A situation may also arise where several people own a portion of the working interests, and each shares in the costs of developing the property. The working interest expires upon termination of the lease; however, the typical lease provides that the lease shall continue as long as production continues.[42]

The development of oil and gas properties may be financed in a number of ways. The manner of financing will have an impact on the availability of the IDC option vis-a-vis the various property interests in the financing arrangement. One method is where the operator may engage the services of a contractor who performs the drilling on a "footage basis." That arrangement provides that the contractor drills to a specified depth at a predetermined dollar amount per foot. Typically, the contractor furnishes all labor, equipment and supplies necessary to drill the well.[43] IDCs incurred under the first two methods are deductible currently or may be capitalized by the operator pursuant to

[41] Treas. Reg. § 1.612-4(a) (1965); Temporary Treas. Reg. § 5a.612-1(a) (1980).

[42] MILLER'S OIL AND GAS FEDERAL INCOME TAXATION 197-98 (J. Houghton ed., 16th ed. 1978) [hereinafter cited as MILLER'S OIL AND GAS].

[43] [1980] 5 STAND. FED. TAX REP. (CCH) ¶ 3553.02.

the option.[44] Two other methods which require more detailed explanation are the "turnkey" contract and the "carried interest" transaction.

A turnkey contract provides that in exchange for payment of a fixed dollar price, the driller will provide the operator with a well completed into the tanks, with the driller furnishing all labor, equipment and supplies necessary for completion of the well.[45] Prior to 1943, IDCs incurred under turnkey contracts were required to be capitalized by the operator on the theory that such costs were part of the purchase price of a capital asset. However, regulations promulgated under the Internal Revenue Code of 1939 pertaining to years beginning after December 31, 1942 and the current regulations both expressly include within the IDC option costs to operators of any drilling or development work done for them by contractors under any form of contract, including turnkey contracts.[46]

However, the notion that certain turnkey contracts require capitalization of IDCs is not dead. This is evidenced by Revenue Ruling 75-304[47] in which a leaseholder agreed to drill sixteen oil and gas wells for several individuals at a fixed turnkey price per well. Each individual was expected to pay a certain fraction of the turnkey price upon completion of each well. Upon payment of the amount due, each would receive an undivided interest in the lease and in all personal property and well equipment attendant with the lease equal to the fraction of the turnkey price paid by that individual. The agreement further provided that if a dry hole were drilled the driller would not receive any payment from the other individuals with regard to that well.

The Internal Revenue Service concluded that the substance of the agreement was the sale by the driller-leaseholder of a producing leasehold interest for an agreed price determined by multiplying the turnkey price of each well times the number of wells. Since the purchasers only incurred liability for each producing well after its completion, they did not obtain the burdens and benefits of the leasehold interest until the well was completed. Under the circumstances, these individuals did not hold any working interest in the property when the IDCs were incurred. The payments made by these individuals were capital expenditures which were required to be capitalized pursuant to the general rule of section 263(a).[48]

Yet another method of financing the development of oil and gas property is the carried interest transaction. Although there are a variety of carried interest arrangements, in general they involve the conveyance of all or part of the working interest by a mineral lessee (the carried party) to another (the carrying party) who agrees to advance

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[44] MILLER'S OIL AND GAS, *supra* note 42, at 335.
[45] [1980] 5 STAND. FED. TAX REP., *supra* note 43.
[46] 4 J. MERTENS, *supra* note 13, at §§ 24.49-.49a.
[47] Rev. Rul. 75-304, 1975-2 C.B. 94.
[48] *Id.*

the funds necessary for drilling the wells and producing the oil or gas. The carrying party agrees to recover the carried party's share of the production, if any. The carrying party assumes the entire risk that there will be insufficient production to cover his investment. The carried party takes no risk, but agrees to wait until the carrying party has recouped his drilling and development costs before receiving any payment on his share.[49]

In one type of carried interest transaction, the owner of the entire working interest assigns 100% of the working interest to the carrying party who agrees to drill and develop the wells. This assignment is subject to the agreement that a fractional portion of the working interest will revert to the carried party after the driller has recouped the cost of drilling and developing the well out of the production. After this reversion, income and expenses are shared proportionately by the carried and carrying parties. In another version, the carried party who owns the entire working interest, assigns a fraction (usually one-half) of the working interest to the carrying party together with an oil production payment covering the portion of the working interest retained by the carried party. The assignment of the production payment terminates after the carrying party has recovered his drilling and development costs from the net production.[50]

In determining whether the carried and carrying parties may deduct the IDCs pursuant to section 263(c), the technical title to the mineral in place is not controlling. The relevant issue is whether the party seeking to deduct the IDCs has an economic interest in the mineral, that is, whether the party must look to the mineral in place as the source of the return of his investment. Moreover, deductions for expenses may be taken only by the party who actually paid or incurred them.[51] It has been held that in the examples described in the previous paragraph, during the period of recoupment, the carried party receives no income and is not entitled to deductions for depletion, depreciation and IDCs. All of the income and deductions go to the carrying party.[52]

Regulation section 1.612-4(a) provides in pertinent part that:

> where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within [the] option . . . . [C]osts of the project undertaken . . . to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.[53]

[49]United States v. Cocke, 399 F.2d 433, 436 (5th Cir. 1968), *cert. denied*, 394 U.S. 922 (1969).

[50]*Id.*

[51]*Id.* at 447.

[52]*Id.* at 436.

[53]Treas. Reg. § 1.612-4(a) (1965); Temporary Treas. Reg. § 5a.612-1(a) (1980).

In reliance upon the above quoted portion of the regulation, the Internal Revenue Service held in Revenue Ruling 75-446[54] that the carrying party was entitled to deduct all of the IDCs. In that transaction, the lessee (carried party) assigned the entire working interest in an oil and gas lease to the driller (carrying party) who agreed to advance all costs of development of the well. The driller could only recover his costs from the production from the well. The agreement further provided that when the driller recovered 200% of the drilling and development costs plus the equipment and operating costs necessary to produce that amount, the entire working interest would revert to the lessee. Thereafter, the driller would have no further interest in the lease. The Service reasoned that since the driller held the entire working interest for the complete pay-out period, he was entitled to deduct all of the IDCs incurred in drilling the well.[55]

RECAPTURE OF IDCs

The Tax Reform Act of 1976 added section 1254 to the Internal Revenue Code of 1954.[56] Section 1254 provides for the recapture of IDCs upon the disposition of oil, gas and geothermal property. A working interest in oil, gas or geothermal property is considered to be "real property" used in a trade or business as defined in section 1231.[57] Therefore, income generated from the sale or exchange of a working interest would receive the same treatment as a capital gain.[58] Although deductions for the depreciation of tangible personal property used in the development of wells were subject to recapture upon disposition under section 1245, prior to 1976 IDCs previously expensed pursuant to section 263(c) were not recaptured upon later disposition of the working interest. Under those circumstances, current deductions could be taken against ordinary income, and any gain resulting from a subsequent sale of the working interest would be treated as a long term capital gain assuming that the requisite holding period requirement had been met.[59] Section 1254 now requires that any gain realized from the disposition of oil or gas property after December 31, 1975 be treated as ordinary income to the extent of at least some of the IDCs expensed after December 31, 1975.[60] In 1978, section 1254 was amended

[54]Rev. Rul. 75-446, 1975-2 C.B. 95.

[55]*Id.*

[56]Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[57]Rev. Rul. 68-226, 1968-1 C.B. 362.

[58]MILLER'S OIL AND GAS, *supra* note 42, at 199.

[59]3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION (Tax Reform Act of 1976 Summaries, Act Sec. 205(a), 3) (1977).

[60]Burke, *Taxation of Natural Resources: Evaluation of Recent Changes and Projection for the Future with Special Emphasis on Oil and Gas Transactions*, 14 HOUS. L. REV. 1075 (1977).

to provide for recapture of IDCs expensed after October 1, 1978 upon the disposition of geothermal property.[61]

Since the enactment of section 1254, no regulations or revenue rulings have been issued regarding that section. Similarly no court cases have been published which interpret the section. In order to understand the workings of section 1254, it is necessary to resort to its legislative history and to regulations promulgated under analagous recapture provisions such as sections 617(d) and 1245.

As a reason for enactment of section 1254, the General Explanation of the Tax Reform Act of 1976 states:

> The provision allowing gain from the sale of oil or gas property to be treated as capital gain without any significant recapture of deductions taken against ordinary income increases the value of an oil and gas tax shelter investment because it permits an investor, who has obtained a deferral of tax through the deduction of intangible drilling and development costs, to convert amounts which would in later years be taken into account as ordinary income into capital gains subject to the lower capital gains tax rates. The opportunity to convert these amounts into capital gains by selling the property occurs in all cases of producing wells where the option to deduct intangible drilling costs has been made. Even apart from the tax shelter consideration, the Congress sees no reason why the principle which applies to other areas of the tax law (i.e., that deductions attributable to property should be subject to recapture if that property is sold or disposed of) should not also apply here.[62]

Section 1254(a)(1) provides:

> (1) ORDINARY INCOME - If oil, gas, or geothermal property is disposed of after December 31, 1975, the lower of—
>
> (A) The aggregate amount of expenditures after December 31, 1975, which are allocable to such property and which have been deducted as intangible drilling and development costs under section 263(c) by the taxpayer or any other person and which (but for being so deducted) would be reflected in the adjusted basis of such property, adjusted as provided in paragraph (4), or
>
> (B) the excess of—
>
> (i) the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of the interest (in the case of any other disposition), over
>
> (ii) the adjusted basis of such interest,
>
> shall be treated as gain which is ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

Paragraph (4) of subsection (a) requires an adjustment when making the paragraph (1)(A) computation of the aggregate amount of expen-

[61] I.R.C. § 1254, *as amended by* Energy Tax Act of 1978, Pub. L. No. 95-618, § 402(c)(1), (2), (3), 92 Stat. 3202.

[62] JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 64-65 (Comm. Print 1976) [hereinafter cited as GENERAL EXPLANATION].

ditures which have been deducted as IDCs. It provides that the amount deducted as expenses for IDCs shall be reduced by the amount by which the depletion deduction under section 611 would have been increased if such IDCs had been capitalized and depleted instead of being expensed. Although paragraph (4) itself does not refer to cost depletion for purposes of the adjustment, the legislative history does.

The relevant House Ways and Means Committee Report states that the amount of IDCs subject to recapture are to be reduced by the amount of cost depletion attributable to those IDCs actually deducted or permitted to be deducted under cost depletion.[63] IDCs which, but for the option to expense, would be added to basis and recovered through depreciation, as opposed to cost depletion, are the IDCs which are to be recaptured. In a footnote, the Committee Report explains that these amounts which would otherwise be subject to depreciation previously escaped recapture under section 1245 because they were deducted as current expenses under section 263(c) and not as depreciation deductions under section 167 nor under sections 168, 169, 184, 185, 187 or 188, as is required by section 1245(a)(2).[64] However, nowhere in the legislative history is it explained why the IDCs which, but for the option, would otherwise be capitalized and recovered through cost depletion are excluded from recapture under section 1254.

As will be recalled from the previous discussion concerning the taxpayer's election to capitalize IDCs rather than to deduct them currently, Treasury Regulation section 1.612-4(b) requires some IDCs to be depleted and others to be depreciated. Where the election is made to capitalize, IDC expenditures which are not represented by physical property, such as expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading and the drilling, shooting and cleaning of wells, must be recovered through depletion.[65] On the other hand, IDCs represented by physical property, such as those used in the installation of casing and equipment and in the construction on the premises of derricks and other physical structures, are to be recovered through depreciation.[66] Thus it would seem that the recapture provision of section 1254 applies to the gain realized upon disposition of the subject property, but only to the extent of the IDCs represented by physical property within the meaning of regulation section 1.612-4(b)(2).

The amount recaptured under section 1254 cannot exceed the amount of gain realized in the case of a sale, exchange or involuntary conversion or the excess of the fair market value of the property over

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[63]H.R. REP. NO. 658, 94th Cong., 2d Sess. 88-89 (1976) [hereinafter cited as H.R. REP. NO. 658].

[64]*Id.* at 89 n.1.

[65]Treas. Reg. § 1.612-4(b)(1) (1965); Temporary Treas. Reg. § 5a.612-1(b)(1) (1980).

[66]*Id.* at § 1.612-4(b)(2); *id.* at § 5a.612-1(b)(2).

the adjusted basis of the property in the case of any other disposition subject to recapture. The Committee Report explains that the amount recaptured is to be treated as gain which is ordinary income and is to be recognized upon disposition of the property, regardless of any other provision of the Internal Revenue Code which would otherwise provide for nonrecognition.[67]

By analogy to the regulations issued under section 617(d) (which is a recapture provision applicable to adjusted exploration expenditures previously expensed upon disposition of mining property and which is strikingly similar to section 1254) further insight can be gleaned as to the meaning of section 1254 beyond that available from a reading of the black letter law of the section. As does section 1254, section 617(d) provides for ordinary income treatment and states that gain shall be recognized notwithstanding any other provision of subtitle A. Regulation section 1.617-4(a)(1) states that ordinary income treatment applies upon disposition of the mining property even though in the absence of section 617(d), no gain would be recognized under any other provision of the Code. As an example, the regulation states that "if a corporation distributes mining property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 617(d), section 311(a) would preclude any recognition of gain to the corporation." No reason suggests itself why this same concept should not apply as well to section 1254.

Although section 1254 does not mention "losses," it is safe to assume by analogy to regulations issued under sections 617(d) and 1245(a)(1) that section 1254(a) does not apply to losses. Neither sections 617(d) nor 1245(a)(1) discuss losses. However, regulation sections 1.617-4(a)(4) and 1.1245-1(d), using almost identical language, provide that sections 617(d) and 1245(a)(1) respectively do not apply if a loss is realized upon a sale, exchange or involuntary conversion of the property nor do the sections apply to any other disposition if at the time of the disposition, the fair market value of such property is not greater than its adjusted basis.

Section 1254(a)(3) defines "oil, gas or geothermal property" as any property (within the meaning of section 614) to which any expenditures described in paragraph (1)(A) are properly chargeable. With regard to mineral interests in oil, gas and geothermal wells, section 614(b)(1)(A) requires that all of a taxpayer's operating mineral interests in a separate tract or parcel of land must be combined and treated as one property. However, section 614(b)(2) permits a taxpayer who has more than one operating mineral interest in a single tract or parcel of land to elect to treat one or more of such operating mineral interests as separate properties.

According to the Committee Report, the recapture provisions of section 1254 are to be applied separately to each property as defined

[67] H.R. Rep. No. 658, *supra* note 63, at 89.

in section 614. Since IDCs are only deductible by owners of the working interest in a property, the recapture provision would appear to apply only to the disposition of working interests as opposed to nonoperating interests, such as an overriding royalty. In situations where a taxpayer owns both an operating interest and a nonoperating interest in a single tract or parcel of land, a disposition of the nonoperating interest should not subject him to recapture with respect to IDCs incurred on the operating interest.[68]

There may be one way to defeat recapture upon disposition available for the owner of a working interest who has already deducted IDCs. From his working interest he could carve out and sell a nonoperating interest, such as an overriding royalty, while retaining the working interest. No recapture should occur on the disposition of the nonoperating interest. If the value of the nonoperating interest was large enough to reduce the value of the remaining working interest well below the amount of IDCs subject to recapture, then little if any recapture would result from a later disposition of the working interest itself.[69]

The election provided by section 614(b)(2) provides a possible avenue of escape from recapture. If a taxpayer who has an operating interest in a single tract containing multiple mineral deposits elects to treat each of those deposits as a separate property, then under the authority of Revenue Ruling 58-231, if a dry hole is drilled in attempting to develop one such deposit, the IDCs incurred in that effort are deducted only from the income of that particular deposit when computing taxable income from the property. By extending the reasoning of Revenue Ruling 58-231[70] into the realm of IDC recapture, it could be determined that a taxpayer who disposes of his entire working interest probably will be subjected to little, if any, recapture in regard to those deposits upon which IDCs have been expended in drilling dry holes. This is true because he should be successful in showing that little or none of the amount realized on the disposition of the tract is attributable to the nonproductive deposits.[71]

As in the case of the disposition of mining property under section 617(d)(2), section 1254(a)(2) provides special treatment for dispositions of portions of oil, gas and geothermal property. Section 1254(a)(2)(A) provides that where there is a disposition of a portion of oil, gas or geothermal property, other than an undivided interest, the entire amount of IDCs attributable to the property are to be allocated to the portion of the property sold or otherwise disposed of to the extent of the amount of gain realized. The Committee Report explains that any

[68]Kennedy & Tanner, *Tax Reform Act of 1976—Minimum Tax, "At Risk," and IDC Recapture Provisions*, 25 OIL & GAS Q. 385, 411 (1977).

[69]Glickman & DeBerry, *Post—1976 Oil and Gas Operations Will Require Careful Planning to Overcome Adverse Effects*, 46 J. TAX. 230, 232 (1977).

[70]Rev. Rul. 58-231, 1958-1 C.B. 247.

[71]Glickman & DeBerry, *supra* note 69.

excess IDCs not recaptured in the first disposition are to be allocated to the remaining portions of the property.[72] Regulation section 1.617-4(b)(1) presents an illustration of a disposition of such a portion of a mining property, as being a sale of forty acres out of an eighty acre tract of land to which exploration expenditures had been deducted.

The Committee Report elaborates upon the actual language of the statute by stating that where a portion of a property is disposed of in a manner which does not give rise to recapture, a proportionate part of the IDCs otherwise recapturable is to be allocated to the portion transferred and will be recaptured upon subsequent disposition by the transferee.[73]

Section 1254(a)(2)(B) governs the recapture of IDCs with respect to dispositions of undivided interests in oil, gas and geothermal property. It requires that a ratable portion of the IDCs attributable to the undivided interest disposed of must be recaptured upon disposition. The Committee Report indicates that the apportionment of the IDCs between the undivided interest disposed of and the retained undivided interest would be determined by the relative rights of the transferor and transferee to income from the property.[74] It has been suggested that the difference in treatment between dispositions of portions of property (other than undivided interests) and undivided interests will encourage dispositions of the latter since the applicable recapture rules are considerably less harsh.[75]

Although the general rule embodied in section 1254(a) appears to apply to all dispositions of oil, gas and geothermal property, this is not the case. Section 1254(b)(1) authorizes the Secretary of the Treasury to prescribe regulations similar to those of section 1245(b) and (c) (relating to certain dispositions not subject to depreciation recapture) and section 617(g) (relating to exclusion of the distribution of property by a partnership to a partner from the recapture of mining exploration expenditures). Therefore if the regulations to be issued under section 1254 faithfully follow the exceptions under 1245(b), then the following dispositions should not trigger recapture under section 1254:

1) Gifts
2) Transfers at death except as provided in section 691
3) Certain tax-free transactions in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of sections 332, 351, 361, 371(a), 374(a), 721 or 731
4) Like-kind exchanges under section 1031 and involuntary conversions under section 1033
5) Transactions under sections 1071 and 1081

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[72]H.R. REP. NO. 658, *supra* note 63, at 90.

[73]*Id.*

[74]*Id.*

[75]Kennedy & Tanner, *supra* note 68, at 417-18.

6) Property distributed by a partnership to a partner
7) Transfers to a tax-exempt organization where the property will be used in an unrelated business.[76]

Similarly, if future regulations under section 1254 adhere to the rule of section 617(g), then if a partner disposes of his interest in a partnership holding an interest in oil, gas or geothermal property, any IDCs subject to recapture under section 1254 will be treated as unrealized receivables. Thus any gain realized by the partner upon disposition of his interest will be ordinary income to the extent of his ratable share of the IDCs. The Committee Report states that similar rules are to apply upon the sale or exchange of stock in a subchapter S corporation.[77]

The Committee Report supports the unspoken rule of section 1254 that in each case where a disposition falls within one of the exceptions to recapture, the recapture is merely deferred to a later disposition, rather than avoided entirely. If the regulations ultimately issued under section 1254 comport with the regulations under section 1245(b), then in the case of a gift of oil, gas or geothermal property, for example, the recapturable IDCs will be allocated to the property transferred. On the other hand, in the case of a like-kind exchange, the recapturable IDCs will be allocated to the property acquired in the exchange.[78]

It is clear that a section 1254 recapture is triggered by a disposition of oil, gas or geothermal property. However, neither the statute itself nor the legislative history defines "disposition" for purposes of this section. Reference has been made to regulation section 1.1245-1(a)(3) which provides for purposes of section 1245, that the term "disposition" does not include a mere transfer of title to a creditor upon creation of a security interest. It has been argued that the security interest concept should be applied under section 1254 also. This would preclude recapture in carved-out product payment transactions, since the owner of a production payment in reality obtains a mere security interest in the minerals to be produced from the particular property involved. The transaction is essentially a loan by the recipient of the production payment with recourse limited to the minerals produced.[79]

It has been asserted that a section 1254 recapture does not apply to carried interest transactions in which the owner of a working interest in a property transfers all or a large portion of that interest to an operator who agrees to bear all the risk of development of the well. The transaction is really a sharing agreement in which, after the pay-out period is completed, the parties share additional income and expenses of operating the property. Because the carried party's transfer of his working interest is not treated as a taxable disposition of his interest, it

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[76]I.R.C. §§ 1245(b)(1)-1245(b)(7).

[77]H.R. REP. NO. 658, *supra* note 63, at 91.

[78]Glickman & DeBerry, *supra* note 69, at 234.

[79]Kennedy & Tanner, *supra* note 68, at 414-15.

should not be considered as a disposition within the meaning of section 1254 which would cause the recapture of IDCs which the carried party had previously incurred with respect to the property.[80]

There is also support for the belief that no recapture should occur after pay-out when a reversion of the fractional portion of the working interest to the carried party occurs. A footnote contained in the General Explanation of the Tax Reform Act of 1976 states that:

> [A]rrangements under which the interests of two or more parties in a drilling venture (such as a leaseholder and a driller) shift after a certain amount of production is obtained are not generally to be considered a disposition where the shift in interests occurs under an agreement made prior to the time that the intangible drilling expenses were paid or incurred.[81]

This footnote seems to be describing the general characteristics of a carried interest transaction.[82]

Just as there is no authority for the recapture treatment to be accorded to the shifting of interests between the parties to the carried interest arrangement, there is no authority for the recapture treatment to be administered when, after reversion, either party disposes of his share of the working interest to a third party. It has been suggested that all of the recapturable IDCs remain with the carrying party's permanent fractional share of the working interest for later recapture upon disposition. This conclusion is reached because the alternative of allocating a ratable portion of the IDCs to each of the fractional shares of the working interest in the hands of carried and carrying parties is unfair to the carried party since the carrying party alone received the benefit of being able to deduct the IDCs as expenses under section 263 (c).[83]

CONCLUSION

As can be seen from the foregoing discussion, the area of IDC taxation is far from being well defined. That fact coupled with the vast amounts of money represented by IDCs provide the potential for considerable litigation in this area. With the advent of recapture affecting dispositions of oil and gas properties after December 31, 1975, and geothermal properties after October 1, 1978, the future should hold in store a multitude of revenue rulings and cases which hopefully will resolve the many questions raised by the statute.

ILLUSTRATIVE EXAMPLE

The following problem illustrates tax treatment of IDCs.

In 1980, *L* owned a tract of land which he had purchased many

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[80] *Id.* at 415-16.

[81] GENERAL EXPLANATION, *supra* note 62, at 67 n.4.

[82] Kennedy & Tanner, *supra* note 68, at 416.

[83] Glickman & DeBerry, *supra* note 69, at 234.

years before for $50,000. It was later discovered that the land contained a single oil deposit which contained an estimated 5,000,000 barrels of oil. Late in 1980, *L* entered into a transaction with *O*, an oil operator, whereby *L* transferred to *O* his entire working interest in the subject property with the understanding that *O* would drill an oil well on the property and that *O* would advance all of the development costs. It was further understood that *O* was entitled to recoup all of his expenses from the entire production of the well and that *L* would have no personal liability for the development costs. However, the understanding was that when *O* had recovered all of his development costs plus operating expenses, then one-eighth of the working interest would revert to *L*. From that time forward, *L* and *O* would share in the income and expenses of the well in proportion to their relative fractional shares of the working interest.

In early 1981, *O* engaged the services of a geologist to locate the optimum spot on the property to drill a well. After a suitable location was found, *O* hired a moving contractor to haul his equipment from another property to the new drill site. *O* hired a local contractor to clear the drill site and grade a road through the pasture land to the nearest public road. *O*'s employees constructed a derrick and erected it on the site. *O* also purchased a new engine to power his drill and 1,000 feet of steel casing to be used in the well. In addition, *O*'s employees dug a sludge pit. Drilling commenced on February 15, 1981 and on March 1, 1981, the well found oil in commercial quantities. The following expenses were incurred and paid for by *O* as of March 1, 1981:

geologist fees	$20,000
hauling of equipment	5,000
derrick construction (labor)	50,000
derrick construction (materials)	20,000
pipes	20,000
storage tanks	50,000
casing	15,000
road construction (labor)	30,000
site clearing (labor)	20,000
engine	10,000
sludge pit (labor)	10,000
drilling (fuel)	40,000
drilling (labor)	75,000
food	10,000
field office supplies and miscellaneous	5,000
installation of casing	10,000
	$390,000

By June 1, 1981, *O* had recovered all of his costs expended up to that date. By prior agreement, one-eighth of the working interest in the property reverted to *L* at that time. Thereafter *L* received one-eighth of the income from the property and was responsible for one-eighth of the expenses of production. By December 31, 1981, the well had produced 100,000 barrels of oil at a price of $10 per barrel.

On February 1, 1983, *L* sold his one-eighth working interest to *Y* for $100,000. On April 1, 1983, *O* gave an undivided one-half interest in his seven-eighth working interest to his son *S* as a birthday present. *S* sold the undivided one-half interest to *B* on May 1, 1984 for $200,000.

1. Assuming that the parties elect to expense IDCs currently, determine which, if any, of the items of development cost qualify for the section 263(c) option.

2. Determine who is entitled to deduct the IDCs.

3. Determine the tax consequences of each transfer of interest in the property after March 1, 1981.

Answer

1. The development costs incurred by *O* may be broken down into items of IDC (currently deductible under the option), business expense items (which must be deducted currently), and capital items (which must be depreciated):

IDCs (Regulation section 1.612-4)

hauling of equipment	$ 5,000
derrick construction (labor)	50,000
road construction (labor)	30,000
site clearing (labor)	20,000
sludge pit (labor)	10,000
drilling (fuel)	40,000
drilling (labor)	75,000
installation of casing	10,000
	$240,000

Business Expense Items (section 162)

food	$10,000
field office supplies and miscellaneous	5,000
	$15,000

Capital Items (I.T. 4006 and Regulation Section 1.612-4(c)(1)

geologist fees (I.T. 4006)	$20,000
derrick construction (materials)	20,000
pipes	20,000
storage tanks	50,000
casing	15,000
engine	10,000
	$135,000

2. The contractual arrangement between *L* and *O* is a "carried interest" transaction. During the whole pay-out period, *O* owned the entire working interest on the property and he paid all the development

costs. Therefore, *O* alone is entitled to deduct all of the IDCs in the year in which they are incurred.[84]

3. Any transfer of interests in oil property upon which IDCs have previously been expensed raises the issue of IDC recapture pursuant to section 1254. The initial inquiry is whether the transfer constitutes a "disposition" which will trigger recapture.

Although the law in this area is unclear, the better view is that the reversion of the one-eighth working interest to *L* at the end of the pay-out period on June 1, 1981 does not constitute such a disposition.[85]

Although *L*'s sale on February 1, 1983 of his one-eighth working interest would qualify as a disposition within the meaning of section 1254(a), *L* was not entitled to deduct any of the IDCs in the year in which they were incurred. If it can be assumed that the law is such that the recapturable IDCs remain with the carrying party's fractional share after reversion of the one-eighth working interest to *L*, then *L*'s sale of that interest will not trigger recapture. *L* will realize a long term capital gain to the extent that the amount realized on the sale exceeds his adjusted basis in the property. This is true because the property in his hands is either a capital asset or section 1231 property.

According to section 1254(a)(2)(B), a disposition of an undivided interest in oil property will ordinarily cause a ratable portion of the IDCs attributable to that undivided interest to be recaptured. However, if the regulations ultimately to be issued under section 1254 comport with those under section 1245(b), then the gift from *O* to *S* of an undivided one-half interest in the seven-eighth working interest will fall within an exception to the general section 1254 recapture rules.[86]

However, the sale by *S* to *B* on May 1, 1984 will trigger recapture of some of the IDCs. This conclusion is based on the assumption that all of the recapturable IDCs remain with the carrying party after the reversion to *L*. It is also based on the further assumption that one-half of those recapturable IDCs will follow the undivided one-half interest in the seven-eighth working interest into the hands of *S* when the gift is made.[87] Therefore, since a sale is clearly a disposition, one-half of the recapturable IDCs should be subject to recapture.

Under section 1254(a)(1), it is first necessary to compute the aggregate amount of IDCs expensed after December 31, 1975, which in our case is $240,000. Next, it is necessary to make the section 1254(a)(4) adjustment. This requires that the paragraph (a)(1)(A) amount be reduced by the amount of the increase in the cost depletion allowance which would have resulted if the IDCs which are not represented by physical property (i.e., those which, if capitalized, must be recovered through depletion) had been capitalized and cost depleted.

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[84]399 F.2d 433.

[85]GENERAL EXPLANATION, *supra* note 62, at 67 n.4.

[86]Treas. Reg. § 1.1245-4(a)(1); I.R.C. § 1254(b)(1).

[87]Glickman & DeBerry, *supra* note 69, at 234.

Therefore, it is necessary to determine which of the IDCs are represented by physical property and which are not. This determination is made as follows:

IDCs represented by physical property
(regulation section 1.612-4(b)(2))

derrick construction (labor)	$50,000
installation of casing	10,000
	$60,000

IDCs not represented by physical property
(regulation section 1.612-4(b)(1))

hauling of equipment	$ 5,000
road construction (labor)	30,000
site clearing (labor)	20,000
sludge pit (labor)	10,000
drilling (fuel)	40,000
drilling (labor)	75,000
	$180,000

Cost depletion is then calculated without reference to section 1254. O's basis in the property would consist only of the $20,000 in geologist exploratory costs because that cost must be capitalized and added to O's basis in the oil property.[88] The other capital items incurred in 1981 (i.e., derrick construction (materials), pipes, storage tanks, casing and the engine) will be capitalized individually and independently of oil property. The formula to be used in computing the cost depletion allowance is that provided in regulation section 1.611-2(a):

$$\frac{\text{O's basis in the oil property}}{\text{\# barrels of oil in the deposit at the beginning of 1981}} \times \begin{array}{c}\text{\# barrels sold}\\ \text{during 1981}\end{array} = \begin{array}{c}\text{cost depletion}\\ \text{allowance}\end{array}$$

Thus the original cost depletion allowance would be computed as follows:

$$\frac{\$20{,}000}{5{,}000{,}000} \times 100{,}000 = \$.004 \times 100{,}000 = \$400$$

Then the cost depletion allowance is computed pursuant to section 1254(a)(4) as follows:

$$\frac{\$20{,}000 + \$180{,}000}{5{,}000{,}000} \times 100{,}000 = \$.04 \times 100{,}000 = \$4{,}000$$

The difference between the two computations of cost depletion allowance is $3,600. That amount is substracted from the aggregate amount of IDCs of $240,000 leaving a balance of $236,400 which is the total amount of recapturable IDCs with respect to O's seven-eighth working interest. Since *O* gave a one-half undivided interest in that

[88] 4 J. MERTENS, *supra* note 13.

fractional working interest to *S*, then one-half of $236,400 of IDCs (or $118,200) follow the undivided one-half interest into the hands of *S* and will be subject to recapture upon his sale to *B* on May 1, 1984.

Because *S* received the undivided interest as a gift, *S* will take a section 1015 carried-over basis in his undivided one-half interest in the seven-eighth working interest. Therefore, his basis in the undivided interest will be one-half of *O*'s $20,000 basis (or $10,000). By virtue of section 1001, *S*'s gain realized on the sale to *B* will be $190,000 ($200,000 amount realized minus $10,000 adjusted basis). Since $118,200 is less than $190,000, then by operation of section 1254(a)(1), *S* will recognize ordinary income in the amount of $118,200 and the balance of $71,800 ($190,000 gain realized over $118,200) will be a long term capital gain.